STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
PETER F. AND BARBARA D. McSPADDEN	:	DETERMINATION DTA NO. 810895
for Redetermination of a Deficiency or for Refund of New York State and New York City Personal Income Tax under Article 22 of the Tax Law and the New York City Administrative Code for the Year 1988.	:	

Petitioners, Peter F. and Barbara D. McSpadden, 46 Carriglea Drive, Riverside, Connecticut 06878, filed a petition for redetermination of a deficiency or for refund of New York State and New York City personal income tax under Article 22 of the Tax Law and the New York City Administrative Code for the year 1988.

A hearing was held before Dennis M. Galliher, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on December 14, 1992 at 9:15 A.M., with all briefs to be submitted by June 7, 1993. Petitioners, appearing by James E. Conway, Esq., submitted a brief on February 16, 1993. The Division of Taxation, appearing by William F. Collins, Esq. (Andrew J. Zalewski, Esq., of counsel), filed a responding brief on April 4, 1993. Petitioners' reply brief was filed on May 27, 1993.

ISSUE

Whether a certain negotiated payment amount received by petitioner Peter F. McSpadden, a nonresident of New York, from his former New York employer constituted New York source income subject in its entirety to New York State and City of New York personal income tax.

FINDINGS OF FACT

Petitioners, Peter F. and Barbara D. McSpadden, timely filed a New York State income tax return for 1988 (Form IT-203) as full-year nonresidents. This return was filed jointly by

petitioners and, at line 1, reflects total compensation (wages, salaries, tips, etc.) in the amount of $2,599,878.00. This figure, in turn, is comprised of amounts paid to petitioner Peter F. McSpadden by his former employer as follows: wages paid through May 31, 1988 ($228,331.00), deferred compensation paid on March 16, 1988 for past services ($521,463.00), and a lump-sum payment made in connection with the termination of petitioner's employment as of May 31, 1988 ($1,850,000.00). In addition, petitioner Barbara D. McSpadden received a small amount of compensation for services performed for the Greenwich, Connecticut Public Library ($84.00).[1] Petitioner reported $128,362.00 as New York source income subject to New York State and City taxation, contending that the balance of his total compensation, including the deferred compensation and employment termination amounts, was not New York source income properly subject to New York State or City taxation. Petitioners' return as filed claimed a refund due in the amount of $132,418.00. However, this claimed refund was not approved for issuance due to pending audit action.

On October 29, 1990, following an audit, the Division of Taxation ("Division") issued to petitioner a Statement of Personal Income Tax Audit

Changes. This statement asserted additional tax due for the year 1988 in the amount of $71,042.42, consisting of New York State tax in the amount of $69,476.57 and New York City tax in the amount of $1,565.85. The calculation of this additional tax was premised upon the Division's position that the entire amount of deferred compensation plus the employment termination payment received by petitioner in 1988 was New York source income properly subject to New York State and City of New York taxation.

On December 6, 1990, the Division issued to petitioner a Notice of Deficiency asserting additional personal income tax due for 1988 in the amount of $71,042.42, plus interest. This

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[1]Petitioner Barbara D. McSpadden's name appears in this proceeding solely by virtue of the fact that petitioners filed a joint return. There is no claim that the compensation paid to Mrs. McSpadden is subject to New York State or City taxes. Hence, all references to "petitioner" shall be references to petitioner Peter F. McSpadden only.

Notice of Deficiency followed and was issued upon the same basis as was set forth in the above-described Statement of Personal Income Tax Audit Changes.

At the commencement of proceedings herein, the parties stipulated to certain facts. Specifically, the parties agreed that as a resident of Connecticut petitioner was entitled to allocate his compensation within and without New York based on a ratio the numerator of which is the number of days worked in New York and the denominator of which is the total number of days worked. In this case, the parties stipulated to an allocation ratio of 55%. In addition, petitioner conceded that the deferred compensation amount received on March 16, 1988 ($521,463.00) was properly taxable by New York State and City to the extent of the 55% allocation. Therefore, the only remaining issue in this proceeding is the treatment of the $1,850,000.00 lump-sum payment received by petitioner in connection with terminating his employment.

As described, petitioner is a nonresident of New York, having lived in Connecticut for over 22 years. Petitioner holds a Bachelor of Arts Degree from Dartmouth College, and served in the United States Navy in the early 1950s. He ended his service in the Navy in 1956, at which time he went into the advertising business. Petitioner was first employed by an advertising firm known as McCann Ericson. Shortly thereafter, petitioner became employed by Danzer, Fitzgerald & Sampler ("DFS"). Petitioner was promoted through the organization at DFS such that he ultimately became its president and chief operating officer.

In 1986, DFS was named advertising agency of the year in an advertising trade publication. At that time, DFS had no international advertising system. DFS was, however, working with another advertising firm, the Dorland Agency of London, England, on an affiliated basis. In or about 1986, the Dorland Agency was acquired by the Saatchi & Saatchi Advertising Agency ("Saatchi & Saatchi"). In turn, Dorland suggested that it should purchase DFS, in what was described as a reverse takeover, and work toward establishing a second international system for Saatchi & Saatchi. This acquisition occurred, and DFS became DFS Dorland Agency. At this time, petitioner described his position as the number two man at the

agency working directly for one Stewart Upson, who was chairman and chief executive officer. Petitioner's title continued to be president and chief operating officer, and his employment terms were set forth in a five-year employment contract with Saatchi & Saatchi.

Some six months after Dorland's acquisition of DFS, Saatchi & Saatchi also purchased the Ted Bates Company, another advertising agency which already had in place an international system. According to petitioner, the funds used by Saatchi & Saatchi to make the Ted Bates Company acquisition were the same funds which were originally to be used by DFS Dorland to build an international system. In light of these circumstances, the Saatchi & Saatchi owners approached petitioner at DFS Dorland, explaining that Saatchi & Saatchi had too many sub-groups and was badly organized. Saatchi & Saatchi suggested that DFS Dorland become a "second" to Ted Bates' international system. Petitioner rejected this suggestion on the grounds that the same would constitute bad management and result in too many client conflicts. In turn, after analyzing DFS Dorland Agency's position, petitioner decided that the best course of action would be for DFS Dorland Agency to take over Saatchi & Saatchi's operations in the United States, known then as Compton Advertising. This takeover occurred and resulted in an entity known as DFS Dorland Compton, working as a Saatchi & Saatchi domestic arm in the United States. Petitioner remained as president, while Stewart Upson remained as chairman.

Petitioner testified that he became "somewhat discouraged" after the last corporate changes, due to the loss of some DFS clients occasioned by agency conflicts, to a loss of key personnel at DFS, and to the fact that he was not entirely free to manage his own agency. Petitioner testified that he considered retirement. At this same period in time, DFS Dorland Compton's clients included RJR Nabisco's Lifesaver and Confections Division and Northwest Airlines. Both of these accounts were headed by petitioner. Northwest Airlines requested the agency to prepare certain advertising to celebrate the fact that Northwest would be banning smoking on its domestic flights. This advertising was in fact prepared and run. In response, RJR Nabisco terminated its relationship with DFS Dorland Compton. Thereafter, the Saatchi & Saatchi owners met with petitioner to discuss certain negative publicity resulting from the

above-described circumstances. Petitioner testified that the Saatchi & Saatchi representatives indicated to him their "desire to reduce the amount of liabilities on their financial statements", and their knowledge that he had been contemplating retirement, stating directly to petitioner that "We'd like to work out a termination agreement with you relative to your contract." Petitioner, in turn, agreed to negotiate toward termination of his employment.

On November 9, 1987, petitioner entered into a letter agreement with Saatchi & Saatchi/DFS concerning the termination of his July 1, 1987 employment contract.[2] Thereafter, on May 25, 1988, petitioner entered into a second letter agreement concerning the termination of his employment. Pursuant to the May 25, 1988 termination agreement petitioner and DFS agreed to a complete satisfaction of petitioner's remaining employment contract, which was to run through December 31, 1990, in exchange for the payment to petitioner of salary and benefits due petitioner through May 31, 1988, plus a lump-sum payment in the amount of $1,850,000.00. The May 25, 1988 agreement indicates that the $1,850,000.00 payment was in complete satisfaction of all of petitioner's rights under and for the remaining balance of his July 1, 1987 employment contract. In addition, petitioner agreed to honor the terms of a previously agreed to restrictive covenant (dated January 1, 1986) pursuant to which petitioner had agreed not to interfere with the business relations of DFS and/or its clients for a period of two years after ceasing his employment with DFS. Petitioner described the May 25, 1988 termination agreement payment of $1,850,000.00 as representing a negotiated amount paid as a "buyout" of the amounts that he would be entitled to for the remaining term of his employment contract

(essentially representing the sum due under that contract discounted to the date of the termination agreement [i.e., the present value of petitioner's full future employment contract

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[2]The July 1, 1987 employment contract appears to be a renewal of petitioner's then-existing five-year employment contract re-executed in order to reflect the then-appropriate corporate employer name resulting after the many corporate changes described hereinabove.

rights]). Petitioner received payment of the $1,850,000.00 sum, net of 20% tax withheld, within 60 days after May 31, 1988.

Petitioner was paid in full for his services rendered to DFS through May 31, 1988, pursuant to the May 25, 1988 agreement. Petitioner did not receive nor was he owed any severance or termination pay, pension monies, or any other form of compensation by DFS for any services rendered before the May 31, 1988 termination date, except for his right to receive monies from DFS's profit-sharing plan in which petitioner had participated for some 29 plus prior years. The profit-sharing payout amount was eventually received by petitioner and was rolled over into a qualified IRA.

Petitioner rendered no services in New York or elsewhere for DFS or any of its related or affiliated entities at any time after May 31, 1988. In fact, the only work petitioner performed after June 1, 1988 was a consulting job for the American Association of Advertising Agencies. This group, and petitioner's work, was unrelated to petitioner's prior employment and was performed out of petitioner's home in Connecticut. Petitioner held no stock or stock rights in DFS or any of its affiliates. Petitioner made no claim for monies for prior services rendered for DFS or any of its affiliates, did not believe he had any such claims, and the same was not a part or factor in the negotiations surrounding petitioner's employment termination.

Upon termination of his employment with DFS, petitioner either relinquished certain fringe benefits to which he was entitled under his employment contract or, if he continued memberships or ownership of assets, he paid DFS the appropriate value therefor (e.g., petitioner paid DFS for the remaining depreciated value of his company automobile which he kept; petitioner repaid DFS for the value of a membership bond in a Connecticut country club).

As its chief operating officer petitioner was in charge of all aspects of DFS's ongoing operations. DFS employed some 1,300 persons in offices within and without New York State, and petitioner's responsibilities included dealing directly with the agency's major clients. As described, much of petitioner's working time was spent out of New York travelling to areas within and without the United States. In response to a question raised on cross examination,

petitioner allowed that if he had remained employed with DFS, his employment would have continued to be within and without New York as had been his pattern over the many years of his employment.

Attached to petitioner's return was an explanatory statement that those wages reflected on petitioner's Wage and Tax Statement (Form W-2) but not allocated to New York represented "payment for future services not to be performed in New York State." This statement was included on the return by petitioners' paid tax return preparer.

CONCLUSIONS OF LAW

A. Tax Law § 631(a) defines the New York source income of a nonresident individual. This section provides:

> "General. The New York source income of a nonresident individual shall be the sum of the net amount of items of income, gain, loss and deduction entering into his federal adjusted gross income, as defined in the laws of the United States for the taxable year, derived from or connected with New York sources . . ." (Tax Law § 631[a]; emphasis added).

Income which is "derived from or connected with New York sources" shall be attributable to "a business, trade, profession or occupation carried on in this state . . ." (Tax Law § 631[b][1][B]).

B. As a nonresident employee, petitioner was required to include in his income derived from New York State (and City of New York) sources that portion of his total compensation for services rendered as an employee which reflects the total number of working days employed within New York State (and City) compared to the total number of working days employed both within and without New York State (and City) (Tax Law § 631; 20 NYCRR 131.4, 132.18, 132.4). The parties have agreed that the proper allocation based on days worked within New York is 55% (66 days divided by 120 days).

C. The issue presented herein has been addressed recently by the Tax Appeals Tribunal in Matter of Laurino (Tax Appeals Tribunal, May 20, 1993). In Laurino, the petitioner entered into an employment contract with The Bowery Savings Bank in New York City in July 1987. His contract provided, in part, that he would be entitled to a severance payment upon a change of control of The Bowery. Such a change of control did occur, after which petitioner entered

into an employment termination agreement with The Bowery in February 1988 that was a direct result of the change of control at The Bowery. In turn, The Bowery paid to petitioner $165,000.00 under the termination agreement in discharge of its obligations to petitioner under the terms of his employment. The Laurinos did not include the termination pay in their New York income and, in turn, the Division issued a Notice of Deficiency subjecting such income to taxation. The Tribunal concluded that the key issue was the consideration given by the petitioner in exchange for the right to the income at issue. The Tribunal held that what The Bowery received from petitioner in exchange for the lump-sum payment was the petitioner's act of continued services to The Bowery up to the time that a change of control occurred. Thus, the Tribunal reasoned that the petitioner's entitlement to the lump-sum payment was secured by the continuing services he performed in New York, that there was no general right to future employment in this instance, and that the Bowery could have terminated the petitioner prior to the change of control for any reason or for no reason at all.

In deciding Laurino, the Tribunal analyzed Matter of Donahue v. Chu (104 AD2d 523, 479 NYS2d 889), cited by both parties herein. The Tribunal specifically stated that it read Donahue:

> "to stand for the proposition that where a nonresident possesses a right to future employment secured by consideration having no connection with New York, and relinquishes that right in exchange for a lump-sum settlement, the lump-sum settlement is not taxable by New York."[3]

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[3] In its decision, the Tribunal included a footnote providing as follows:

> "Further support for this reading is found in 20 NYCRR former 131.5 which states in relevant part:
>
> '[I]tems of income . . . attributable to intangible personal property of a nonresident individual . . . do not constitute items of income . . . derived from or connected with New York State sources . . . .' (see, McKinney's Cons Laws of NY, UCC § 9-106, Official Comment [Contract Rights Included Within the Definition of "General Intangibles"]; cf., Matter of Walsh, Tax Appeals Tribunal, November 19, 1992 [held that income received by a nonresident taxpayer in accordance with a contract where the consideration for the income was the taxpayer's past services in New York is New York source income (citing 20 NYCRR former 131.4[d])])."'

In sum, the Tribunal concluded that "the consideration given by the petitioner in exchange for the right to the income at issue is the

controlling factor" (Matter of Laurino, supra, citing Matter of Halloran, Tax Appeals Tribunal, August 2, 1990).

D. In light of the foregoing decisions and analysis, this matter must be resolved in petitioner's favor. That is, under the facts of this case petitioner was clearly entitled to employment with DFS under the terms of his employment contract through December 31, 1990. As in Donahue, petitioner held a right to future employment for a definite term secured by his mere promise to work in the future. In turn, the lump-sum payment at issue was consideration received in exchange for petitioner's surrender of an item of intangible personal property (his employment contract's remaining term value). The facts of this case do not bear out, as the Division suggests by brief, that the lump-sum payment was taxable as compensation for personal services under 20 NYCRR 132.4(d) as representing: (a) an amount received in connection with the termination of employment, (b) an amount received upon early retirement in consideration of past services rendered, (c) an amount received upon retirement for consultation services, and/or (d) an amount received upon retirement under a covenant not to compete. More specifically, in this case (unlike the Laurino matter in which the payment was described as a severance payment) petitioner did not receive severance pay or other like amounts in connection with agreeing to terminate his employment. Further, petitioner was compensated for all services rendered up to his termination date (May 31, 1988) and was owed no monies for past services. He did not perform any future services or employment of any nature for DFS or any of its affiliates, and thus was not paid upon retirement for consultation services. Finally, with respect to payment under a covenant not to compete, the agreements did reference a prior restrictive covenant entered into by petitioner in January 1986. As the facts bear out, petitioner agreed to honor this existing agreement not to compete. However, the facts

do not support the conclusion that the payment petitioner received upon termination was made in exchange for a covenant not to compete. In sum, the payment in question was not compensation for personal services rendered, but rather was a payment made in exchange for and as a buyout of petitioner's future contractual right to employment. Accordingly, petitioner was not required to include as income subject to tax by New York State and City the $1,850,000.00 lump-sum payment made in exchange for relinquishing the balance of the term of his contract of employment (Matter of Donahue v. Chu, supra; Matter of Laurino, supra).

E. The petition of Peter F. and Barbara D. McSpadden is granted to the extent that the $1,850,000.00 termination payment is to be excluded from New York source income, the Notice of Deficiency dated December 6, 1990 is to be recomputed in accordance herewith, and the Division is directed to refund to petitioner such sum as is due in accordance with such recomputation.

DATED: Troy, New York
September 9, 1993

/s/ Dennis M. Galliher
ADMINISTRATIVE LAW JUDGE